UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

NOT FOR PUBLICATION

In re:	:	Chapter 7
SUPREMA SPECIALTIES, INC., et al., Debtors,	:	Case No.: 02-10823 (JMP)
HARLEYSVILLE WORCESTER MUTUAL INSURANCE COMPANY and LUMBERMENS MUTUAL CASUALTY INSURANCE COMPANY, Plaintiffs,	:	
-against-	:	Adversary Proceeding
FLEET NATIONAL BANK, individually and as Agent for, and a member of the Bank Group, CITIBANK, N.A.; FIRST PIONEER FARM CREDIT, ACA; PNC BANK, NATIONAL ASSOCIATION; GE CAPITAL CFE INC.; GENERAL ELECTRIC CAPITAL CORPORATION; UNITED TRUST BANK; SOVEREIGN BANK; SUPREMA SPECIALTIES INC., SUPREMA SPECIALTIES WEST, INC., SUPREMA SPECIALTIES NORTHEAST, INC., And SUPREMA SPECIALTIES NORTHWEST, INC., Defendants.	:	No. 02-02293 (JMP)

OPINION DENYING PLAINTIFFS' MOTION FOR SUMMARY JUDGMENT AND GRANTING DEFENDANTS' MOTION FOR SUMMARY JUDGMENT

A P P E A R A N C E S:

WESTERMAN, HAMILTON & SHEEHY LLP
Attorneys for Harleysville Worcester Mutual Insurance Company
100 Quentin Roosevelt Boulevard, Suite 502
Garden City, NY 11530

Vincent Torna, Esq.
Matthew F. Diadora, Esq.
Of Counsel

WESTERMAN, BALL, EDERA, MILLER & SHARSTEIN LLP
Attorneys for Lubermans Mutual Casualty Insurance Company
170 Old Country Road, Fourth Floor
Mineola, NY 11501

Thomas A. Draghi, Esq.
Of Counsel

MAYER, BROWN, ROWE & MAW, LLP
Attorneys for Bank of America
1675 Broadway
New York, NY 10019

Michael P. Richman, Esq.
Of Counsel

SILVERSTEIN, PERLSTEIN & ACAMPORA, LLP
Attorneys for Kenneth Silverman, the Chapter 7 Trustee
100 Jericho Quadrangle, Suite 300
Jericho, NY 11753

Jay S. Hellman, Esq.
Of Counsel

JAMES M. PECK
United States Bankruptcy Judge

Plaintiffs Harleysville Worcester Mutual Insurance Company ("Harleysville") and Lumbermens Mutual Casualty Insurance Company ("Lumbermens") (collectively, the "Plaintiffs" or the "Sureties") have brought this adversary proceeding against a group of prepetition lenders to recover amounts paid by the Sureties under a bond procured by the Debtors and issued for the benefit of the New York State Commissioner of Agriculture and Markets (the "Commissioner")[1]. The bond was issued to guarantee payment to suppliers of milk to the Debtors and is part of a statutory scheme to protect New York

[1] Capitalized terms used but not defined herein shall have the meanings ascribed to them in the Plaintiffs' and Defendants' stipulation of undisputed material facts, which is undated but was filed on April 14, 2006.

milk producers from economic loss. The Debtors are also named as Defendants. The material facts are undisputed, and the Plaintiffs and the Defendants have moved separately for summary judgment.

Plaintiffs seek judgment on the alternative theories of (i) equitable subrogation arising out of a default by the Debtors in paying certain suppliers that ripened into a postpetition payment to the Commissioner under the Sureties' bond and (ii) an express trust or an assignment of prepetition contracts or proceeds in accordance with language appearing in a General Agreement of Indemnity. By virtue of these theories, Plaintiffs contend that proceeds of designated contracts for the sale of milk were segregated from the Debtors' property, set aside for their exclusive benefit and never became subject to the blanket lien granted by the Debtors in favor of the Bank Group (as defined below).

The Bank Group disputes these theories and seeks summary judgment in its favor on grounds that Plaintiffs' claims against the Debtors were purely contingent as of the petition date and did not become fixed until the date months later when the Sureties made payment under the applicable surety bond. As a result, the Bank Group submits that any equitable subrogation claim could not have arisen until it was too late to attach to any identified assets or proceeds. As a result, both the Bank Group and the chapter 7 Trustee assert that the Plaintiffs' claim to recover advances under the surety bond should be treated simply as an unsecured claim. The Court agrees with the position of the Bank Group and the Trustee, denies the Plaintiffs' Motion for Summary Judgment and grants summary judgment in favor of the Bank Group for the reasons set forth in this opinion.

JURISDICTION

The Court has subject matter jurisdiction over this adversary proceeding pursuant to §§ 1334 of title 28 of the United States Code, the July 10, 1984 "Standing Order of Referral of Cases to Bankruptcy Judges" of the United States District Court for the Southern District of New York (Ward, Acting C.J.) and 157(b) of title 28 of the United States Code. This is a core proceeding as defined under 28 U.S.C. § 157(b)(2)(A)(E) and (K) because Plaintiffs seek the imposition of an equitable lien on and the recovery of property of the estate that was previously distributed to the Bank Group (as defined below). Venue is proper pursuant to §1409 of title 28 of the United States Code. The parties do not dispute that the Court has jurisdiction, that this matter is a core proceeding, and that venue is proper.

FACTUAL BACKGROUND

The Sureties, the Bank Group and the Trustee have entered into a stipulation of undisputed facts. This stipulation, relevant portions of which are summarized below, provides the factual underpinnings for this opinion.

Suprema Specialties Inc., Suprema Specialties West, Inc., Suprema Specialties Northeast, Inc. and Suprema Specialties Northwest, Inc. (collectively, "Suprema") and certain related entities were manufacturers, marketers and distributors of gourmet Italian cheeses. Suprema was licensed by the Commissioner as a milk dealer, and had a cheese processing facility in Ogdensburg, New York (the "Ogdensburg Facility").

On or about September 23, 1999 (or after such date, through assignment), Fleet National Bank, individually and as a member of and as agent for a consortium of financial institutions (in such capacity, the "Agent", and both individually and as Agent

subsequently succeeded by Bank of America), Citicorp, N.A., First Pioneer Farm Credit, ACA, PNC Bank, National Association, GE Capital CFE Inc., General Electric Capital Corp., UnitedTrust Bank, Sovereign Bank (collectively, the "Bank Group," and together with Suprema, the "Defendants") entered into a Third Amended and Restated Revolving Loan, Guaranty and Security Agreement (as the same may have been amended and modified from time to time, the "Loan Agreement") with Suprema Specialties, Inc., as Borrower and other guarantors (the "Guarantors"). The Loan Agreement provides, among other things, the following:

> (a) that Suprema could borrow up to $140 million in loans from the Bank Group;
>
> (b) a requirement that Suprema submit a Borrowing Base Certificate (as defined in the Loan Agreement) certified by the chief financial accounting officer of Suprema by the 15th day of each calendar month which demonstrates, among other things, that Suprema maintained an appropriate ratio of loans outstanding under the Loan Agreement to Eligible Receivables and Eligible Inventory (as such terms are defined in the Loan Agreement);
>
> (c) that the Agent, on behalf of the Bank Group, is granted a right of setoff; and
>
> (d) that the line of credit was secured by a first priority lien and security interest in all of Suprema's assets, property and the proceeds thereof including: (i) "all Accounts" (as defined in the Loan Agreement); (ii) "all contract rights" and(iii) "any and all deposits (general or special, including, but not limited to, indebtedness evidenced by certificates of deposit, whether matured or unmatured but not including trust accounts) and any other indebtedness at any time held or owing by the Agent and/or any Bank to or for the credit or the account of the Borrower and/or the Guarantor . . ."

The Agent filed financing statements in respect of its security interests, and Plaintiffs have not alleged any defect relating to the perfection of these security interests.

New York Agriculture and Markets Law ("AML") § 258-b requires milk dealers to provide the Commissioner with security guaranteeing the prompt payment of their obligations to milk suppliers. On or about October 15, 2001, in order to meet its obligations under AML §258-b, Suprema requested that the Plaintiffs provide a bond in

the penal amount of $5,100,000 to Suprema Northeast, Inc., as principal and naming the Commissioner as obligee (the "Bond"). The Bond satisfies the obligation of Suprema, as a milk dealer, to provide security for the payment of milk purchased from producers. In consideration for the Bond, Suprema executed a General Agreement of Indemnity in favor of Harleysville, dated December 5, 2000 (the "Harleysville Indemnity Agreement") and a Commercial General Indemnity Agreement in favor of Lumbermens, dated October 30, 2001 (the "Lumbermens Indemnity Agreement," together with the Harleysville Indemnity Agreement, the "Indemnity Agreements"). At the time the Plaintiffs posted the Bond and entered into the Indemnity Agreements, the Plaintiffs knew that a secured financing facility existed in favor of the Bank Group.

The Indemnity Agreements contain, among others, the following provisions that are relevant to the Sureties' claims:

> "2. RESERVE – DEPOSIT
> If for any reason the SURETY shall deem it necessary to set up or to increase a reserve to cover any possible liability or loss for which the PRINCIPAL(S) AND INDEMNITORS will be obligated to indemnify the SURETY under the terms of this Agreement, the PRINCIPAL(S) AND INDEMNITORS will deposit with the SURETY, immediately upon demand, a sum of money equal to such reserve and any increase thereof as collateral security to the SURETY for such liability or loss."
>
> "4. TRUST FUND
> All payments received for or on account of any CONTRACT shall be held in a trust fund to assure the payment of the obligations incurred or to be incurred in the performance of any CONTRACT and for labor, materials, and services furnished in the prosecution of the work in any CONTRACT or any extension or modification thereof. All monies due and to become due under any CONTRACT are also trust funds, whether in the possession of PRINCIPAL(S), INDEMNITORS or otherwise. The trust funds shall be for the benefit and payment of all obligations for which SURETY may be liable under any BOND(S), and this Agreement and declaration constitute notice of such trust. The trust funds, unless otherwise restricted or regulated by state or local laws, can be commingled with other funds, but the trust fund nature and purpose as stated in

> this paragraph shall not be modified nor waived by this commingling provision. PRINCIPAL(S) shall, upon demand of the SURETY and in implementation of the trust or trusts hereby created, open an account or accounts with a bank or similar depository designated by the PRINCIPAL(S) and approved by the SURETY, which account or accounts shall be designated as a trust account or accounts for the deposit of such trust funds, and shall deposit therein all monies received pursuant to said contract or contracts. Withdrawals from such accounts shall be by check or similar instrument signed by the PRINCIPAL(S) and countersigned by a representative of the SURETY. Said trust or trusts shall terminate on the payment by PRINCIPAL(S) of all the contractual obligations for the payment of which the trust or trusts are hereby created or upon the expiration of twenty years from the date hereof, whichever shall occur first."
>
> "5. ASSIGNMENT
> With respect to each BOND(S) executed by the SURETY, the PRINCIPAL(S), the INDEMNITORS hereby consenting, hereby assigns, transfers and conveys to the SURETY but subject to the trust herein created, (A) [a]II monies due or to become due to the PRINCIPAL(S) arising out of or in anyway related to the CONTRACT(S) covered by the BOND(S) . . . ; (B) [a]ll the rights of the PRINCIPAL(S) in, and growing in any manner out of, all contracts referred to in the Bond(s), or in, or growing in any manner out of the Bond(s) . . . .

The Plaintffs made no demand specifically referencing Section 2 of the Indemnity Agreements to establish a reserve deposit, and Suprema did not deposit a sum of money equal to a reserve as described in Section 2 of the Indemnity Agreements. Additionally, the Plaintiffs made no demand that Suprema open an account or accounts with a bank or similar depository designated by Suprema as a trust account or accounts for the deposit of such trust funds, and Suprema never opened any such trust account or accounts for the benefit of the Plaintiffs. The Plaintiffs also made no demand that Suprema segregate any funds for their benefit, and there is no specific evidence that Suprema ever segregated any such funds. Furthermore, the Plaintiffs did not file any UCC financing statements against Suprema relating to the Indemnity Agreements.

In or about December 2001, prior to the Petition Date (as defined below),

Suprema's chief financial officer and controller resigned without notice. On or about December 21, 2001, Suprema issued a press release publicizing these resignations, the SEC commenced an investigation of Suprema and NASDAQ halted trading in Suprema's stock. The Borrowing Base Certificate for the month ended December 31, 2001 (delivered January 23, 2002) indicated that Suprema had $13,342,938 of availability under the Loan Agreement. In January and February 2002, the Bank Group learned that certain receivables listed as "Eligible Receivables" and certain inventory listed as "Eligible Inventory" on Borrowing Base Certificates previously delivered by Suprema were fictitious, in whole or in part, and that the collateral securing the loans made under the Loan Agreement was significantly less than Suprema had represented to the Bank Group.

On or about January 28, 2002, the Federal Bureau of Investigation, the Food and Drug Administration, the New Jersey Department of Health, and the New Jersey Department of Agriculture commenced investigations of Suprema; the FBI searched Suprema's premises pursuant to a search warrant and seized a majority of the corporation's books and records (the "Records Seizure"). Investigations, several of which are still pending, have demonstrated that certain of Suprema's officers participated in a significant fraud and that Suprema's growth in the years prior to the bankruptcy was an illusion, produced in large measure by a fraudulent scheme involving "round-trip" sales or circular transactions associated with the hard cheese part of Suprema's business. *In re: Suprema Specialties, Inc. Securities Litigation*, Nos. 04-3716 & 04-3755, 2006 WL 408205 (3d Cir. Feb. 23, 2006).

On January 30, 2002, the Agent, on behalf of the Bank Group, sent Suprema a

reservation of rights letter advising Suprema that, based on (i) the resignation of chief financial officer Steven Venechanos and controller Arthur Christensen, (ii) obtaining additional information about the relationship between Suprema and certain of its customers, (iii) the death of Suprema's former chief operating officer and (iv) the Records Seizure, a material adverse change had occurred in breach of the representation and warranty in Section 9.7 of the Loan Agreement and that as a consequence, the Agent and other members of the Bank Group had determined to discontinue extending credit to Suprema.

In early February, 2002, the Bank Group began a review of Suprema and its business operations in order to gauge the Bank Group's exposure on Suprema's then outstanding indebtedness to the lenders. As part of such efforts, as provided in the Loan Agreement, the Bank Group received confidential financial information relating to Suprema's operations and financial condition. Given the challenges facing the company, on or about February 4, 2002, Suprema, with the consent and support of the Bank Group, as is common in such distressed situations, retained an independent crisis management firm that was given the responsibility to review aspects of and attempt to stabilize Suprema's business operations and to limit disbursements to those that were absolutely necessary. The crisis manager was expressly permitted under terms of its retention to share information about Suprema with the Bank Group.

On February 5, 2002, Harleysville demanded that Suprema discharge the Plaintiffs from the Bond or post an irrevocable letter of credit in the amount of $5,100,000 for the benefit of the Plaintiffs as security for the obligations under the Indemnity Agreements by February 12, 2002. Suprema never responded to that demand.

On February 19, 2002, the Plaintiffs demanded that Suprema provide records and documents detailing milk ordered from, and payments made to, New York milk suppliers. The Sureties also requested information concerning payments received from, and accounts receivable for, milk and milk products sold by Suprema. Suprema did not respond to that demand either.

Suprema terminated the engagement of its first crisis manager on February 19, 2002 and the next day the board hired another firm. The new crisis manager attempted to obtain control over Suprema's cash flow and, together with Suprema, to analyze payables and determine which payments to make.

During the period January 15, 2002 through February 23, 2002, Suprema purchased $3,882,571.19 of milk from Allied Federal Cooperatives, Inc. ("Allied"), a federation of New York dairy farm cooperatives (the "Allied Transaction"). Allied delivered the milk to the Ogdensburg Facility and, as directed by Suprema, to other manufacturing facilities in New York which were not operated by Suprema. According to a determination (the "Determination") made by the Commissioner, the milk sold by Allied to Suprema was subject to Part 1001 – Milk in the Northeast Marketing Area (7 CFR Part 1001; "Northeast Federal Order"). Under the Northeast Federal Order, the Commissioner determined that "Suprema was required to pay Allied by January 26, 2002 for milk received January 1-15; by February 16, 2002 for milk received January 16-31, 2002 and any balance owing for milk purchased January 1-15, 2002; by February 26, 2002 for milk received February 1-15, 2002; and by March 16, 2002 for milk received February 16-24, 2002 and any balance owing for milk purchased February 1-15, 2002. Suprema made a payment of $1,442,835.87 to Allied on January 28, 2002 for the milk

received January 15, 2002. The Debtors did not make the payments due on February 16, 2002 or thereafter.

A significant portion of the Allied Transaction milk was purchased by Suprema and resold through Dairy Market Services, LLC ("DMS"). DMS is a partnership between Dairy Farmers of America and Dairy Lea Cooperative Inc. ("Dairy Lea"). Approximately $2,123,793 of the milk purchased as part of the Allied Transaction was delivered directly to Kraft. Suprema received payments at various times for milk sold through DMS to Kraft from both Kraft and Dairy Lea amounting to approximately $2,362,297 for milk purchased as part of the Allied Transaction.

On February 19, 2002, Allied's counsel demanded payment from Suprema of $1.7 million for milk delivered in the second half of January, but Suprema did not respond to this demand for payment. On that same date, the Bank Group through the Agent advised Suprema of a number of specified additional defaults under the Loan Agreement relating to the Records Seizure and failures to provide required financial reporting and exercised their right to setoff all deposits (but not including trust accounts). The Bank Group subsequently swept the Debtors' accounts of all funds at a time when it knew that Suprema's payments to its milk suppliers were backed by one or more bonds and that payment terms to the milk suppliers were extremely short.

On February 24, 2002 (the "Petition Date"), Debtors filed voluntary petitions for relief under chapter 11 in this Court. As of the Petition Date, Suprema and the Guarantors were indebted to the Bank Group in the principal amount of approximately $97,565,837.50, plus interest and fees. The chapter 11 cases were converted to cases under chapter 7 on March 20, 2002, and thereafter Kenneth P. Silverman was

appointed as the chapter 7 trustee (the "Trustee") and was authorized to operate the business of the Debtors.

On May 3, 2002, the Commissioner made a claim under the Bond in the amount of $3,882,571.19 based upon Suprema's failure to pay Allied for milk purchased in the Allied Transaction. On May 7, 2002, in response to Suprema's Application in Support of a Stipulation and Order by and Between the Trustee and the Bank Group Regarding the Distribution of Collateral Proceeds in Connection With the Liquidation of Assets, dated April 29, 2002 (the "Stipulation and Order"), the Plaintiffs filed an objection to the proposed Stipulation and Order and specifically reserved their rights to proceed against the Bank Group and Suprema to recover the proceeds disbursed in connection with the Stipulation and Order.

On or about June 5, 2002, the Plaintiffs paid the Commissioner $3,882,571.19 and have filed a proof of claim in this amount. In connection with resolving their objections to the Trustee's settlement with certain of Suprema's officers, directors and insurance carriers, Plaintiffs received a payment of $140,000 pursuant to a Stipulation of Settlement in or about November 2005, by which the Plaintiffs agreed to reduce both their proof of claim and the damages sought in this adversary proceeding by such amount. Members of the Bank Group are still owed in excess of $75 million.

This adversary proceeding was commenced on May 6, 2002. Following denial by Judge Blackshear of a motion to dismiss this action brought by the Bank Group, the Sureties filed their Third Amended Complaint on April 25, 2003. The amended complaint was based on theories of an alleged contractual trust and assignment in favor of the Sureties, unjust enrichment, equitable subordination of the claims of the Bank

Group traceable to proceeds of the Allied Transaction and common law principles of equity and subrogation. On April 28, 2006, the Sureties withdrew their claim for relief based on the doctrine of equitable subordination.

DISCUSSION

Summary Judgment Standard

The Sureties and the Bank Group each agree that this case is now ripe for an adjudication and that the entry of summary judgment is proper because there is no genuine issue as to any material fact. There is no agreement, however, as to which of the moving parties, on the basis of these undisputed facts, is entitled to judgment as a matter of law. In considering cross-motions for summary judgment, the Court must evaluate the merits of each motion independently of the other. *Heublein, Inc. v. United States*, 996 F.2d 1455, 1461 (2d Cir. 1993).

Notably, both sides in this inter-creditor dispute have cited and rely upon many of the same cases. This adversary proceeding, therefore, is a prime example of a case that is well suited for summary judgment under the standards set forth in Rule 56(c) of the Federal Rules of Civil Procedure and Rule 7056 of the Federal Rules of Bankruptcy Procedure, the only question being which moving party is entitled to judgment as a result of applying the law to the facts. Having independently considered the facts and legal authorities, the Court has determined that summary judgment should be granted in favor of the Bank Group.

Analysis

The doctrine of Equitable Subrogation

Subrogation has its roots in natural justice and equity. Subrogation means "[t]he substitution of one person in the place of another [as] to a lawful claim, demand or right, so that he who is substituted succeeds to the rights of the other [as] to the debt or claim, and its rights, remedies, or securities." *Black's Law Dictionary* 1427 (8th Ed. 2004). "Subrogation appears commonly in construction contracts, insurance contracts, suretyship, and negotiable instrument law." *Id.* It is a prerequisite to the right of equitable subrogation that the party seeking subrogation must have paid another's obligation, and this payment must have fully satisfied the debt owed by the other party to that creditor. *Thornton v. Syracuse Sav. Bank*, 961 F.2d 1042,1047 (2d Cir. 1992); *In re Daley*, 222 B.R. 44 (Bankr. S.D.N.Y., 1998). Whether the doctrine of subrogation is applicable depends upon the facts and circumstances of each case. The remedy is broad enough to include every instance in which one person, not acting as a volunteer, pays a debt for which another is primarily liable and which in equity and good conscience should have been discharged by the latter. *Williston on Contracts*, § 61:51 (4th Ed. 1990)

Here, the parties agree that subrogation applies, but they differ regarding the date this right first arose and the legal significance of that right. The Bank Group's position is that the Sureties' equitable subrogation claim did not arise until after the petition date when the Sureties were called upon to make a postpetition payment under the Bond and became subrogated to the rights of the unsecured seller of milk to Suprema. The Bank Group submits that this result is what the Sureties bargained for and is mandated by case law: a surety's equitable lien is recognized as arising only in a contingent sense upon

execution of the bond and cannot be enforced or attach to anything until loss is actually incurred. *Safeco Ins. Co. of Am. v. State of N.Y.*, 392 N.Y.S.2d 976, 979 (N.Y. Ct. Cl. 1977); *Reliance Ins. Co. v. U.S. Bank of Wash., N.A.*, 143 F.3d 502 (9th Cir. 1998) ("At common law, a surety does not become subrogated to its principal's right to payment from a third party until the surety performs the principal's obligations.").

The Bank Group's logic is that subrogation requires performance, and the Sureties could not perform until they paid on Suprema's behalf under the Bond. That payment required a Determination by the Commissioner that did not occur until three months after the start of the bankruptcy case. The resulting claim, consequently, can have no greater stature than the same claim in the hands of the original creditor. Stepping into the shoes of Allied, an unsecured milk supplier, entitles the Sureties to no more than the unsecured claims held by that supplier.

The Sureties counter that their subrogation claim relates back to Suprema's default in failing to pay Allied on February 16, 2002. Most of the cases cited for the proposition that an equitable lien came into existence as of that date are taken from the construction industry. The concept as explained by the Supreme Court is that "if the surety at the time of adjudication was··· either the outright legal or equitable owner of [the] fund, or had an equitable lien or prior right to it, this property interest ··· never became a part of the bankruptcy estate to be ··· distributed to general creditors of the bankrupt." *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 9 L. Ed. 2d 190, 83 S. Ct. 232 (1962)

The Sureties also rely heavily on certain language in Bankruptcy Judge Cyganowski's opinion in *Mendelsohn v. Dormitory Auth. (In re QC Piping Installations,*

Inc.), 225 B.R. 553 (Bankr. E.D.N.Y. 1992). They contend that the *QC Piping* case supports the proposition that the prepetiton default gave the Sureties an equitable interest in property of Suprema similar to a vested property right. The language from *QC Piping* relied on by the Sureties is as follows:

> "In the case presently pending, the Debtor has defaulted and the surety, by completing the project and paying laborers and materialmen, has stepped into the shoes of the Debtor, prior to the filing. Whatever rights the Debtor had in the contract passed to the surety by virtue of the doctrine of subrogation, prior to bankruptcy." 225 B.R. at 568

When read in context, however, this excerpt from *QC Piping* does not apply to the Sureties' claims against Suprema or the Bank Group because the facts and circumstances in this case are significantly different. The Court concludes that the notion advanced by the Plaintiffs that their equitable subrogation claim should be deemed to predate both the bankruptcy filing and the payment to the Commissioner is without merit.

The *QC Piping* case involves a construction contract in which the surety not only guaranteed completion of a project by QC Piping for the benefit of the Dormitory Authority of the State of New York ("DASNY") but actually stepped in to complete construction of the project after the contractor's prepetition default . Prior to this default by the debtor contractor, DASNY had made periodic payments under the construction contract and had held back five percent of these payments as retainage. QC Piping's chapter 7 trustee sought to recover this retainage claiming that it was property of the estate under section 541 of the Bankruptcy Code. The bankruptcy court extensively analyzed the law relating to the rights of construction sureties in bankruptcy cases, including *Pearlman v. Reliance Ins. Co.*, *supra*, and found that the retainage was not

property of the estate; even if it were property of the estate, the trustee had only bare legal title that was subject to the surety's equitable right to the fund.

The *QC Piping* precedent upon close examination helps the Bank Group more than the Sureties. A payment default by Suprema to Allied is not the functional equivalent of a default by a contractor under a bonded construction contract, and the analogy offered by the Sureties to a construction setting is strained at best. The Bond was not a performance bond; it functioned as a payment guarantee providing the Commissioner with security guaranteeing the prompt payment of Suprema's obligations to milk suppliers. The equitable subrogation rights of the Sureties were contingent or inchoate when the default occurred on February 16, 2002, and, given the nature of the Sureties undertaking to the Commissioner, these rights could not be asserted until payment under the Bond. Unless and until the Commissioner sought payment under the Bond it remained possible that the obligation to Allied might be satisfied and the default cured from other sources (such as proceeds of DIP financing provided by the Bank Group or third parties; given the discovery of fraud at Suprema, these hypothetical payment alternatives are more theoretical than real but serve to demonstrate that the default did not mean that payment under the Bond was inevitable under all circumstances). Although the Sureties were facing a loss that was highly likely[2], they had not been called upon to pay anything on their principal's behalf nor had they offered to do so.

Unlike the surety in *QC Piping*, the Plaintiffs had no prepetition obligations to perform (or that they could have performed) as surety at the time of the payment default

[2] Their demand on February 5, 2002 to be discharged as surety or for a letter of credit as security for their benefit indicates concern at the time regarding their exposure.

to Allied and had no reserve account, hold back, retainage, segregated account or other separately identified property of Suprema from which to seek payment or against which to assert lien rights. The Sureties' obligation to pay under the Bond did not fully ripen until June 5, 2002. Plaintiffs are left, as a result, with a claim that, because of the secured claims of the Bank Group and the lack of any carve out from those claims, can attach to no unencumbered property.

The Sureties subrogation rights give them no more than the rights that Allied would have had as an unsecured seller of milk - - the rights to assert unsecured claims for Suprema's failure to pay and breach of contract. See *Gluck v. Seaboard Sur. Co. (In re E. Freight Ways, Inc.*), 577 F.2d 175, 180 (2d Cir. 1978) ("Normally, a surety to an insolvent principal is without recourse against the principal except insofar as the surety may ultimately receive some dividend from the bankruptcy proceedings"); *In re Enron Corp*, 307 B.R. 372 (S.D.N.Y., 2004) (sureties' subrogation claims not superior to those of unsecured creditors).

Equitable subrogation gives the surety that pays under its bond the right to recover amounts advanced on behalf of a principal by allowing the surety to substitute itself for the creditor whose claim has been satisfied, but this right does not extend to stripping away property from the estate or trumping the properly perfected liens of other creditors. This is not a construction case, and precedent from that industry dealing with prepetition performance is inapposite. Consistent with the business risk they assumed when the Bond was issued, the Sureties' equitable subrogation claims did not become noncontingent and fixed until they made the postpetition payment to the Commissioner on June 5, 2002 pursuant to the Determination. Accordingly, while Plaintiffs do have

subrogation rights, those rights are not at the expense of the Bank Group. Given the timing of payment under the Bond, Plaintiffs' resulting postpetition claim for subrogation gives them only the right to receive a percentage distribution as members of the class of unsecured creditors. As stated in *In re Chateaugay Corp.*, 89 F.3d 942, 948-49:

> "It is no injustice to limit the surety's recovery to that of an unsecured creditor. Understanding the risks of serving in that capacity, presumeably it incorporated those risks into its rates when issuing policies and binding itself as surety. One of the risks was that its insured would go bankrupt and would be unable to meet its financial obligations to its [suppliers]. The surety would then be obligated to pay the [suppliers] and would be left holding a claim in the reorganization, in which recovery is uncertain."

This result is compatible with New York law and public policy. New York State milk suppliers are granted the right to make a claim against a bond but not to assert a lien on account of nonpayment. The legislative history of AML § 258 provides: "It is declared to be the policy of the state to protect independent milk producers and cooperatives against loss of payment for milk because of defaults by purchasers, so that such milk producers will be able to continue the production of an adequate and wholesome supply of milk for the consuming public." (N.Y. Laws ch. 526, § 1, 1975, N.Y. AGR & M § 258-b (McKinney 2006)). Recourse to a bond is part of an established statutory scheme that protects producers such as Allied and indirectly the consuming public as well, but the surety that issues such a bond either is assuming the risk of incurring a loss under that bond or needs to take appropriate measures to assure itself of having a reimbursement claim on which it can collect. As discussed below in the section dealing with the express trust and assignment claims of the Sureties, Plaintiffs did not adopt such protective measures in this case.[3]

[3] The request for an irrevocable letter of credit was made too late and was ignored.

Trust and Assignment Provisions of the Sureties' Indemnity Agreement

The Sureties also look to certain language embedded in their form Indemnity Agreements to support their argument that they should be treated more favorably than other creditors. They contend that provisions in the Harleysville Indemnity Agreement establishing an express trust and an assignment of monies due arising out of or related to the milk contracts covered by the Bond apply to both Sureties, even though (i) Suprema took no action to segregate, earmark or separately account for any proceeds of milk contracts subject to the coverage of the Bond, including proceeds of the Allied Transaction and (ii) the Sureties never demanded reserves or trust accounts. The question presented is whether the language of the Harleysville Indemnity Agreement, without more, is sufficient to establish an express trust or an assignment of proceeds of the Allied Transaction.

The answer depends upon whether the parties clearly manifested their intent to enter into a trust relationship and whether their conduct was consistent with maintaining such a relationship.

Under New York law[4], an express trust must have (1) a designated beneficiary, (2) a designated trustee who is not the beneficiary, (3) an identifiable trust *res*, sufficiently identified to enable title to pass to the trustee and (4) actual delivery or assignment of the *res* with the intent of vesting legal title to the trustee. *Agudas Chasidei Chabad v. Gourary*, 833 F.2d 431, 433-34 (2d Cir. 1987); *In re Ames Dep't Stores, Inc.*, 274 B.R. 600, 623 (Bankr. S.D.N.Y. 2002)*; In re State Street Associates, L.P.* 323 B.R. 544 (Bankr., N.D.N.Y. 2005). The formation of a trust relationship is dependent upon the intention of the parties, which, if not clearly indicated by the language of the parties,

[4] Both Plaintiffs and Defendants agree that New York law applies.

is to be inferred from all the circumstances. *Stratford Financial Corp. v. Finex Corp*. 367 F.2d 569 (2d Cir. 1966).

The language of a surety's General Agreement of Indemnity has been held to establish a trust relationship that is valid and enforceable under applicable state law. See *In re Alcon Demolition, Inc.* 204 B.R. 440 (Bankr. D. N. J. 1997) (applying New Jersey law to trust language appearing in a construction surety's Agreement of Indemnity). If this were a construction case like *Alcon*, and if the language of the paragraph creating the trust were as clearly expressed as the language in *Alcon* ("It is expressly understood and declared that all monies due or to become due under any contract or contracts covered by the Bonds *are* trust funds. . ." 204 B.R. at 448 (emphasis added)), the Court might be inclined to reach the same conclusion, particularly if the Sureties had taken reasonable steps to protect their interests in the trust *res*. The Court finds, however, that the language of the Harleysville Indemnity Agreement is not clear on its face in failing to specifically address the particulars of Suprema's business, thereby creating doubt as to the intention to create a trust. Boiler plate terms from the construction industry do not have clear meaning in the context of a payment bond for a business that buys and processes milk.

Here, the trust fund is a creature of Harleysville's Indemnity Agreement. This agreement is a standard form document prepared by and for the protection of the Sureties and typically used as a means to secure payment or performance in a construction industry setting. The Suprema entities are the indemnitors under this agreement and have agreed in paragraph 4 that "All payments received for or on account of any CONTRACT shall be held in a trust fund to assure the payment of obligations incurred or to be

incurred in the performance of any CONTRACT and for labor, materials, and services furnished in the prosecution of the work in any CONTRACT or any extension or modification thereof…." This language plainly is part of a form agreement drafted with construction contracts in mind ("labor, materials, and services in the prosecution of the work" describes a construction project, not contracts for the supply of milk). The extraneous references to the construction trades introduce uncertainty as to whether the parties really meant to create an enforceable trust for all payments received by Suprema relating to the purchase and sale of milk. It would be easier to infer that such a trust existed if the Sureties had insisted upon segregated accounts for the deposit of contract payments or had demanded that reserves be set up or set aside. Then, at least, the conduct of the parties would be congruent with and support the interpretation urged by the Sureties.

As a standard form agreement prepared by the Sureties, the printed "trust fund" language of the Harleysville Indemnity Agreement should be construed most strongly against the party who prepared it, and favorably to a party who had no voice in the selection of its language. See *Flagg v. Yonkers Sav. And Loan Assn.*, 307 F. Supp. 2d 565 (S.D.N.Y. 2004). Applying, with this weighting in mind, the legal standards for an enforceable trust under New York law to the language of section 4, the Court finds that only the first two of the four requirements for a trust are satisfied. There is a designated beneficiary (the Sureties; "The trust funds *shall be* for the benefit and payment of any obligations for which SURETY may be liable under any BOND(S)." (emphasis added)) and a designated trustee (Suprema, as principal or indemnitor). However, the third and fourth requirements are not satisfied due to ambiguities in the two subparagraphs that

comprise section 4 of the Harleysville Indemnity Agreement and the failure to identify a separate trust fund for payments made to Suprema .

The first sentence of section 4 does not declare that the payments received by Suprema for or on account of any contract *are* trust funds (as in *Alcon*, *supra*), but rather that these payments "shall be held in a trust fund" (not *as* a trust fund, but *in* a trust fund, indicating the need to hold, deposit or segregate the payments). Additional wording in that same sentence states that the purpose of the trust fund is to assure payment of obligations in the performance of any CONTRACT and for labor, materials and services furnished in the prosecution of the work. This first sentence of the "Trust Fund" section, read literally, says that payments held in a trust fund are to assure payment of contractual obligations and labor, materials and services. This is a "Trust Fund" that conceivably may function in a construction setting as a way to cover payment obligations in connection with contracts relating to a building project but that has no relevance when applied to the Bond payment made to the Commissioner after Suprema defaulted in its payment to Allied. The commingled receivables collected by Suprema were never set aside as an identifiable fund or *res* and to characterize these undifferentiated collections as a trust for the exclusive benefit of the Sureties is to impose a fiction, convenient to the Sureties, on the reality of Suprema's prepetition business. That business was in disastrous shape during the period following the Records Seizure and leading up to the bankruptcy filing, and this first sentence of section 4 can not be read as imposing an express trust for the exclusive benefit of the Sureties when Suprema's financial affairs were so distressed and Suprema had never treated any proceeds of any contract as if it were acting as a trustee for the Sureties. No one disputes that the Debtors' accounts

included fraudulent entries and were a tangled mess. Suprema itself needed a trustee, and at the time certainly was not acting as one.

The second sentence of the first subparagraph purports to dispense with the requirement that funds must be delivered to a trustee (Suprema) to be held in trust by declaring that "All monies due *and to become due* under any CONTRACT are also trust funds whether in the possession of PRINCIPAL(S), INDEMNITORS *or otherwise*" (emphasis added). This sentence incorrectly and improperly disregards the element of delivery with the intent of vesting legal title in Suprema and attempts to extend the "trust funds" label to payments that have not yet been made, received or even become due.

The second subparagraph of section 4 creates additional ambiguity. Referring to this paragraph, the Bank Group argues that no express trust was created because the Sureties never demanded that payments be deposited in a segregated trust account. The pertinent language reads "PRINCIPAL(S) shall, upon demand of the SURETY and in implementation of the trust or trusts hereby created, open an account or accounts with a bank or similar depository . . . designated as a trust account or accounts . . ." The question is whether a separate deposit of payments in a trust account is essential to trust creation or is simply a means of implementation of a trust that was effectively created under provisions of the first subparagraph.

The first subparagraph declares that payments shall be held in a trust fund, and the second subparagraph provides for opening of trust accounts by Suprema upon demand of the Sureties. When read together these subparagraphs provide for payments to be held in a trust fund and, upon demand, for such payments to be deposited in a separately identified trust account. Suprema, in fact, never set up a separate trust fund and no

demand was ever made by the Sureties for the opening of trust accounts. The failure of the Sureties to *demand* that Suprema open a trust account by itself is not fatal, but it is fatal that Suprema did nothing to evidence that it was holding contract payments in a trust fund. The provisions of section 4 are insufficient by themselves to establish a valid trust without some minimal segregation or identification of the payments made to Suprema (with or without a separate trust account) to evidence holding in a trust fund.

The Sureties are unable to prevail on a trust fund theory because Suprema took no action to distinguish those payments that were supposed to be subject to the alleged trust from Suprema's other cash receipts. Additionally, the commingling of funds, even though expressly permitted under section 4 of the Harleysville Indemnity Agreement, effectively destroys any ability to separately identify the subject matter of the alleged trust at this point, and is consistent with a debtor-creditor relationship, not a trust. *In re Ames*, 274 B.R. at 623; *see also* COLLIER ON BANKRUPTCY p. 541.11[5] (15th ed. Rev. 2006). The Sureties have also failed to show that any identified payments (including payments related to the Allied Transaction) were delivered or assigned to Suprema with the intent of passing legal title to Suprema as trustee.

The Sureties, as provided in Section 5 of the Harleysville Indemnity Agreement, also assert a claim to the proceeds of the Allied Transaction based on an assignment of all monies arising out of or in any way related to the contracts covered by the Bond. The contracts themselves are not otherwise identified and no action, including the filing of UCC financing statements, was taken by the Sureties to perfect their claim to these contract proceeds. Because the Bank Group has a validly perfected security interest in

the same proceeds, the unperfected assignment claim of the Sureties is insufficient to defeat the superior claim of the Bank Group.

CONCLUSION

For the foregoing reasons, the Court grants the Motion for Summary Judgment in favor the Bank Group and denies the Motion for Summary Judgment of the Sureties. The Bank Group shall settle an order consistent with this opinion.

Dated: New York, New York
June 8, 2006

s/ James M. Peck
UNITED STATES BANKRUPTCY JUDGE